Summary of Significant Research on Challenges and Opportunities for Emerging Firms Prepared by Mosaic Investment Advisors

Robert Toigo Foundation, “Achieving Market Share Growth Through Investment Consulting Relationships”, June, 2004. (see Appendix A)

A survey conducted to identify the opportunities and challenges faced by minority-owed investment firms and developing investment managers in increasing their market share of institutional assets under management. It focused on the role of the investment consulting firm as an influential participant in allocating funds among investment managers and surveyed 13 of the largest U.S. firms. The findings address the identification and tracking of minority-owned firms, women-owned firms and developing firms; investment manager search activity and mandates awarded to these firms in the three years prior; opinions on the investment strategies that can provide the greatest opportunities for these firms and recommendations for enhancing the success of the firms in growing institutional business. A summary of highlighted findings follows:

- Identifying and Tracking - 12 of 13 firms track minority firms (typically defined as >50% minority ownership); same criteria used for women-owned firms; developing firms are less likely to be tracked and criteria varies widely. Established search policies are generally not changed in order to specifically include minority and developing managers. Minority managers represent 8% on average of the firms included in consultant databases – which track primarily managers with public market investment strategies. Non-traditional investment strategies get little attention by consultants. Vendor databases are less likely to have data on small firms than the proprietary databases used by the largest firms.
- Investment Manager Searches – Overall, about 7% of all investment mandates in the past three years included a minority and developing manager as candidates, with about 2% resulting in a final award to such managers which reflects 76 final awards across 4,655 total client searches conducted by 10 responding firms. Few searches (about 4%) established a preference or request that these firms be included and fewer (about 3%) required that only these firms be included. More common are informal requests for such managers, thus not a part of the formal search guidelines. Public plans have led the way in requesting the inclusion of these managers in searches and the assets under management by these managers reflect the impact of mandates from public plans, i.e., 85% public, 13% corporate, 2% other.
- Opportunities – Participation in a Fund-of-Funds or Manager-of-Manager product drew mixed responses – advocates cite the benefit of a specialist identifying managers that might not otherwise meet consultant criteria – detractors cite another layer of expenses which can erode the returns. Size of potential mandates in relation to the size of the investment firm was cited as the most common limitation for minority and developing managers. Equities (specialty strategies and core) were suggested as offering the most potential for firms with few mentions of fixed income and alternative asset strategies. Establishing a Fund-of-Funds was also cited as a good opportunity.

New America Alliance, "American Latinos in Financial Services – Phase I White Paper", October, 2003. (see excerpt at Appendix B)

This paper was prepared by this organization of American Latino business leaders with the intent to: a) highlight challenges faced by American Latinos in the investment management consulting, asset management, private equity, and brokerage financial sectors; b) identify key constituents and agents of change who can help resolve these challenges; c) raise awareness on these issues among key agents of change and d) support American Latino financial firms in the development and implementation of action plans that will provide them with increased participation in the market.

Surveys were collected from the membership including 35 firms, one association and 2 non-profit organizations focused on the four financial services areas listed above. The paper provides a general description of each sector, lists respective challenges and offers key constituents/agents of change and action plans. The following were cited as challenges in these sectors:

- Minimal representation by Latinos in the investments industry overall (one consulting firm, <20 asset management firms, 6 private equity firms)
- Access to key decision makers at corporate and public pension funds
- Barriers created by consultants who play a critical role in the asset management industry, i.e., favoring larger firms with longer track records, unwillingness to meet minority managers unless instructed by clients
- Meeting the firm size, capital requirements, track record and other criteria used by institutional investors and their consultants to evaluate firms for investment allocations and brokerage relationships
- Perception that investment performance will not meet return expectations, or that investing has only a social responsibility purpose

Action plans by constituency groups included:
Elected and Appointed Officials - conduct hearings at the local, state and congressional levels with the participation of pension fund executive directors, trustees and consultants to help facilitate the inclusion of Latino firms; conduct studies at the state level to assess the Latino community assets; pass legislation to encourage pension funds to increase minority participation.

Pension Funds and Corporations - increase the representation on pension boards; public funds should report annually on their inclusion of Latino asset managers; public, quasi-public and corporate funds should be encouraged to create and enforce special programs to include Latinos as their investment management consultants, asset managers, private equity funds and broker/dealers; create staff positions; pension funds should include diversity criteria in the evaluation of financial service providers; Latino professionals should develop closer working relationships with "gatekeeper" consultants.

Pension Consulting Alliance, Inc., "A Review of Developing Managers and Developing Manager Programs", a study for the California State Teachers' Retirement System, April, 2003. (see Appendix C)

This paper was prepared for CalSTRS as part of their consideration to fund smaller "developing" investment management firms. PCA interviewed several peer plan sponsors and leading practitioners involved with developing managers, and reviewed the investment performance of developing managers and compared their results with those of their "mainline" counterparts. The consultants acknowledged that this segment of the industry was non-standardized and that it was difficult to get a complete picture but offered the following as key findings:

- To meet its added value objectives, CalSTRS, like other large scale plan sponsors, has utilized the expertise of large scale investment firms. These firms have produced mixed results over the last investment cycle. A relatively small group of investment firms invest the bulk of institutional assets globally, with the top 20 firms controlling nearly 50% of all institutional assets.
- Plan sponsors have begun to focus on "developing" investment firms by establishing programs in a variety of formats with the expectation that the managers will produce investment results competitive with mainline managers. (Descriptions of the programs of 15 plan sponsors are provided)
- PCA reviewed recent investment performance of domestic equity products sponsored by small "developing" firms and found that there is no broad-based difference between the performance of products of small firms versus those of their larger more established mainline counterparts**. Within specific mandates, the products of smaller investment firms exhibited some evidence of better investment results** – while limited, these results are consistent with recent theoretical research.
- There is a developing consensus about how a developing manager program should be implemented. Key components cited were: i) clear policies and objectives, ii) a significant degree of flexibility, iii) a well-designed monitoring system, iv) access to a proprietary and continually evolving database, and v) an allocation of assets that is meaningful to both the plan sponsor and the developing manager.

HFR Asset Management, "Emerging Manager Out-Performance: Alpha Opportunities from the Industry's Newest Hedge Fund Managers", 2005. (see Executive Summary at Appendix D)

An analysis of hedge fund managers comparing emerging managers (managers with less than a two year track record) with the overall hedge fund market and with more established hedge funds during the period of January, 1995 – December, 2004. The analysis concludes that:

- Funds in their early years tend to outperform funds in their later years, with the most out-performance occurring in the first 12months. Emerging managers can offer significant potential through alpha-pursuing strategies driven by 1) greater incentive of young managers to outperform to attract assets, 2) the nimble nature of smaller funds to focus on their best investment ideas and 3) the application of specific expertise to niche exposures.
- New funds offered by new managers significantly outperform new funds by existing managers during the first year.
- While emerging managers can provide significant potential as a group, there are challenges to selecting the right managers and monitoring operational risks. Funds in their

first years of operation have high mortality rates. A key source of failures is poorly managed operational and business risks.

- The 564 managers tracked by Hedge Fund Research, Inc. for this analysis provide broad representation across the major hedge fund strategies (i.e., equity, convertible arbitrage, distressed securities, event driven, macro, equity market neutral, and relative value arbitrage). This diversity provides the potential to mitigate some of the risks inherent with emerging managers.
- Access to a representative basket of funds launched by new managers represents a material return opportunity relative to general hedge fund industry performance.

Timothy Bates, William Bradford, and the Ewing Marion Kauffman Foundation, "Minorities and Venture Capital", 2003. (see Executive Summary at Appendix E)

An analysis of venture capital investments in minority business enterprises as undertaken by 24 venture capital funds making 117 minority-oriented investments during the period of 1989 – 1995. The venture capital funds were all members of the National Association of Investment Companies (NAIC), whose members are investment companies bound together by their shared interest in financing minority business enterprises.

Key findings were as follows:

- Minority enterprise venture capital investing is very profitable, (i.e., 23.9% mean IRR (11 funds) and 54.7% of 117 investments had positive paybacks). Funds with the highest levels of involvement in their portfolio companies earn higher rates of return than the less active funds.
- Minority-oriented venture capital funds do not concentrate their investments heavily in high-tech firms – industries included communications, manufacturing, wholesale and retail trade, services, and medical. All of the funds had participated in some form of deal syndication, including 20 firms that had acted as the lead firm.
- Public pension funds are the leading source of venture capital funds for minority business enterprises. The larger scale minority-oriented VC funds were most often capitalized by the public and corporate pension funds, fund-of-funds and banks. New industry entrants find access to funding primarily from banks and insurance companies with government, corporations, foundations, endowments and individuals providing smaller amounts. Estimated total capital under management in the minority VC sector as of 2001 was $2 billion.

The analysis concludes with these observations:

- Successful investing of new money may support continued rapid growth in this industry niche.
- The investment mix is less risky than the overall industry so, the minority sector may exhibit less of the extreme boom and bust nature that has plagued the VC industry since its inception.
- Knowledge of the high returns generated by successful minority venture capital investments will lessen the negative impact of assumptions of low-return "social investing" by profit-oriented funding sources.

RG & Associates/Council of Urban Investors Institute, Plan Sponsor and Minority Manager Consortium, June, 2004 (see excerpt at Appendix F)

This inaugural event held in New York brought together pension plan sponsors, endowment funds, consulting firms, investment management firms, investment banking firms, brokerage firms, and others supportive of expanding the presence of minorities within the financial services industry. Its purpose was to create a collaborative environment for information sharing between plan sponsors and minority investment firms regarding new products, best practices and new investment opportunities. The program details and sponsor information are attached.

Progress Investment Management Company, "A Dialogue on Emerging Managers & Related Topics", 10th Annual Plan Sponsor & Emerging Manager Conference, November, 2004

This is a summary of the proceedings at the annual client and manager conference. The topics addressed from an emerging manager perspective included: corporate governance, risk and compliance, the search for alpha, minority brokerage, marketing and presentation strategies and emerging manager myths vs. reality. The closing session was a town hall meeting during which the group discussed several questions about the status and future outlook for emerging firms. Comments from that discussion are summarized below.

"Are we going to see more Emerging Manager-of-Manager searches in 2005?"

- "Yes, …data supports the idea that it's not only doing good but being good"
- Survey underway with emerging managers indicates that 80% of the respondents think that there is going to be increasing use of the manager-of-manager structure in the future. Top three reasons: performance, diversification and efficiency/access/ease of use.

"What are some of the commonly held myths regarding Emerging Managers?

- "…question that comes up quite frequently is related to the enterprise risk of the organization"
- "….there is a perception that it's an awful lot of work for very little extra return"
- "….perception of lack of competitiveness and competence is a real problem"
- Survey asked managers what are the top three things that you wish the plan sponsor and consulting community knew about emerging managers that they don't know. Responses: emerging managers have unique discipline, creative investment process; emerging managers add value; and small AUM size doesn't necessarily mean extra risk, given the depth, experience and the talent at the firms. Survey of Progress' managers shows that almost 60% of the respondents had from 11 to over 20 years of portfolio management experience.

"Is the "Emerging Manager" niche an asset class?"

- "No….we hope that managers within our program will graduate to developed manager or mainstream fund manager. They are domestic equity managers. That's your asset class."
- "…there are some asset class characteristics – the dispersion of returns, the availability of talent. Maybe there is no passive benchmark yet, but these are some things to think about."

"What is the appropriate allocation to emerging managers, relative to the total portfolio?"

- "…I don't think that we should have a set amount, because we don't want to put limits on ourselves…."
- "…The allocation to small managers should in fact, if you're trying to produce alpha, be much, much larger."
- "…manager-of-manager allocations for a recent period ---percentages range anywhere from one-tenth of one percent up to….12%

"What is the capacity in this niche? Will the universe continue to expand?"

- "…the universe will continue to expand. There is a niche for entrepreneurs…it could not be considered an asset class…but a class of managers that could be different from other managers…precisely because the capacity to produce alpha may be there better than in a Fidelity or some huge manager that has everything."

"What is the cost or benefit of being hired by an emerging manager-of-managers? What is the cost or benefit of hiring an emerging manager-of-managers?"

- "…it doesn't make sense for me to reinvent the wheel….For me to go out and try to meet with consultants as a small emerging manager, they want a five-year track record, they want the $100-200 million of assets under management. It's a catch-22 for the emerging manager."
- "What it brings to us and I think to everyone is credibility in the marketplace."
- Survey of the managers cited three downsides: Fees are low; volatility of asset flows; and extra effort.
- Top three benefits for managers were: Credibility, access/visibility to hard to reach clients and additional AUM.
- "…hiring an emerging manager-of-managers …it was very cost effective for us versus hiring and bringing the program in-house, which was something we were going to do."
- For plan sponsors, on the issue of whether there are double costs in working with a manager of emerging firms, the Progress analysis indicated that potential in-house costs for analysts and support staff would be substantially higher than the manager-of-manager annual costs.

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